

Company Focus

31 October 2007 | 10 pages

Hindustan Unilever (HLL.BO)

3Q07: Facility Closure Hurts More than Expected; See a Better 4Q

- Facility closure impacts 3Q** — We underestimated the impact of the Assam facility lockout for 7 weeks in 3Q. This facility contributes almost 30% of HUL's personal care sales. The lockout affected profits in more than one way:
 1. Personal care sales growth slowed to 4%, against our estimate of 8%. We were building in a slowdown, but the extent of this surprised us.
 2. Lower margins: Personal care is the highest margin segment for HUL and lower sales hurt overall margins. On top, personal care margins declined by 255bps as well, absorbing the fixed costs of a shut facility.
 3. Higher taxes: The Assam facility is a tax-free facility and products manufactured here are exempt from excise and income tax. Lower production in Assam resulted in a higher income and excise tax rate in 3Q.
- Primary sales continue to be strong** — According to HUL management, overall demand continued to be strong and HUL's sales growth suffered only on account of supply-side disruptions. The Assam facility is back in operation now, and 4Q will see strong recovery in personal care sales and margins.
- Market shares are stable** — In addition, HUL's market shares across most of its segments, including personal care, are stable in 3Q, suggesting steady primary sales and corroborating the management view that growth will recover in 4Q.
- Maintain Buy (1L)** — Maintain Buy (1L) rating with TP of Rs254. HUL's stock price correction of 5.2% following the results enhances the buying opportunity.

Buy/Low Risk	1L
Price (31 Oct 07)	Rs213.90
Target price	Rs254.00
Expected share price return	18.7%
Expected dividend yield	3.4%
Expected total return	22.2%
Market Cap	Rs471,463M US\$11,983M

Price Performance (RIC: HLL.BO, BB: HUVR IN)



Statistical Abstract

Year to	Net Profit	Diluted EPS	EPS growth	P/E	P/B	ROE	Yield
31 Dec	(RsM)	(Rs)	(%)	(x)	(x)	(%)	(%)
2005A	14,082	6.40	17.6	33.4	20.4	64.0	2.5
2006A	18,554	8.43	31.8	25.4	19.2	78.0	3.2
2007E	17,624	8.01	-5.0	26.7	18.6	70.8	3.2
2008E	20,709	9.41	17.5	22.7	18.0	80.7	3.7
2009E	23,949	10.88	15.6	19.7	17.4	90.1	4.3

Source: Powered by dataCentral

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Fiscal year end 31-Dec	2005	2006	2007E	2008E	2009E
Valuation Ratios					
P/E adjusted (x)	33.4	25.4	26.7	22.7	19.7
EV/EBITDA adjusted (x)	31.2	27.0	23.4	19.6	16.6
P/BV (x)	20.4	19.2	18.6	18.0	17.4
Dividend yield (%)	2.5	3.2	3.2	3.7	4.3
Per Share Data (Rs)					
EPS adjusted	6.40	8.43	8.01	9.41	10.88
EPS reported	6.40	8.43	8.01	9.41	10.88
BVPS	10.47	11.15	11.47	11.86	12.30
DPS	5.39	6.74	6.81	8.00	9.25
Profit & Loss (RsM)					
Net sales	110,605	121,034	135,406	150,816	166,166
Operating expenses	-97,416	-105,855	-117,872	-129,773	-141,439
EBIT	13,189	15,179	17,534	21,043	24,727
Net interest expense	-192	-107	-150	-150	-150
Non-operating/exceptionals	3,048	3,545	3,722	3,909	4,104
Pre-tax profit	16,046	18,617	21,106	24,802	28,681
Tax	-2,500	-3,220	-3,483	-4,092	-4,732
Extraord./Min.Int./Pref.div.	536	3,157	0	0	0
Reported net income	14,082	18,554	17,624	20,709	23,949
Adjusted earnings	14,082	18,554	17,624	20,709	23,949
Adjusted EBITDA	14,434	16,481	18,903	22,481	26,233
Growth Rates (%)					
Sales	11.4	9.4	11.9	11.4	10.2
EBIT adjusted	0.2	15.1	15.5	20.0	17.5
EBITDA adjusted	0.4	14.2	14.7	18.9	16.7
EPS adjusted	17.6	31.8	-5.0	17.5	15.6
Cash Flow (RsM)					
Operating cash flow	24,786	17,756	19,750	24,463	27,908
Depreciation/amortization	1,245	1,302	1,370	1,438	1,506
Net working capital	9,460	-2,099	757	2,316	2,454
Investing cash flow	1,509	-714	-2,845	-4,598	-4,936
Capital expenditure	-645	-1,000	-1,000	-1,000	-1,000
Acquisitions/disposals	2,154	286	-1,845	-3,598	-3,936
Financing cash flow	-27,530	-16,720	-16,905	-19,865	-22,972
Borrowings	-14,142	31	0	0	0
Dividends paid	-13,388	-16,750	-16,905	-19,865	-22,972
Change in cash	-1,235	323	0	0	0
Balance Sheet (RsM)					
Total assets	64,809	70,265	74,993	81,442	88,177
Cash & cash equivalent	3,550	6,000	6,000	6,001	6,001
Accounts receivable	10,623	13,027	14,498	16,079	17,673
Net fixed assets	14,835	14,534	14,164	13,726	13,221
Total liabilities	41,752	45,728	49,738	55,343	61,101
Accounts payable	29,594	31,383	34,734	38,332	41,956
Total Debt	569	600	600	600	600
Shareholders' funds	23,056	24,537	25,255	26,100	27,076
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	13.0	13.6	14.0	14.9	15.8
ROE adjusted	64.0	78.0	70.8	80.7	90.1
ROIC adjusted	nm	na	na	na	na
Net debt to equity	-12.9	-22.0	-21.4	-20.7	-19.9
Total debt to capital	2.4	2.4	2.3	2.2	2.2

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3Q07 Results Analysis

- 1. Sales:** 3Q07 sales grew 9.7% yoy, below our expectations. The key negative surprise was significant slowdown in personal care sales, which grew only 4% yoy against our expectations of 8% growth. Personal care products sales were affected on account of a 7-week closure of a facility (Assam) that manufactures personal products. The facility was locked out on account of labor-related issues. According to the management, this facility accounts for almost 30% of personal products production. While we were factoring in the closure of this facility into our estimates, we did not anticipate such a sharp slowdown, as we expected HUL to be able to shift its production to its other facilities. According to the HUL management, while manufacturing was shifted to other facilities, the company had to prioritize 'Fair & Lovely' and 'Clinic All Clear' brands, as these were re-launched in 3Q. As a result, oral care and other skin creams production suffered adversely. However, secondary sales continued to remain strong, and the slowdown was more on account of HUL not being able to feed the demand. The Assam facility is back in operation since September, and management expects personal products sales to get back on track in 4Q. As such, given that pipeline inventories are below average levels, we expect a strong spike up in personal care products sales in 4Q. Soaps and detergents sales grew 12.8%, as per our expectations, while foods and beverages grew 26.6% and 13%, respectively. Detergents sales grew slightly ahead of soaps segment. Soaps segment has been witnessing a slowdown in volumes post price hikes to mitigate cost pressure, and growth has been price led. We need to wait and see if HUL would be able to take further price hikes on soaps without further affecting volumes.
- 2. Margins:** EBITDA margins in 2Q were flat (up about 16bps), against our expectations of a 100bps margin expansion. While overall advertising expenditure was down by 56bps, margin expansion did not come through, mainly on account of an inferior product mix (lower proportion of higher margin personal care sales) as well as the impact of the Assam factory closure. Gross margins were flat (15bps increase) despite higher raw material costs, mainly on account of price hikes affected by HUL. Soaps and detergents EBIT margins improved 436bps, driving 52.7% EBIT growth for the segment. However, personal products segment EBIT declined 255bps, which management has attributed to facility closure resulting in an adverse impact on operating efficiency as well as higher excise payout and higher advertising expenditure on the segment. Personal products segment is the most profitable segment for HUL, and we would be concerned if its margins are not restored in 4Q.
- 3. Profits:** Pre-exceptional net profits grew 6.9% yoy, pared by a higher tax rate, which increased 250bps yoy. The higher tax rate was on account of lower production from the Assam facility, which is a tax-free manufacturing unit. Management has guided at full-year tax rate close to about 19%, we therefore expect 4Q tax rate to be lower than 3Q.

Figure 1. HUL – 3Q07 Results Summary (Rupees in Million, Percent)

Year to 31 Dec	3Q2006	3Q2007	% Change
Net Sales	30,660.1	33,646.3	9.7
Domestic FMCG	27,240	29,976.3	10.0
Exports	3,270.0	3,135.8	-4.1
Other sales	480.0	534.2	11.3
Total Expenses	-26,631.3	-29,170.4	9.5
EBITDA	4,028.8	4,475.9	11.1
<i>EBITDA margin (%)</i>	<i>13.1</i>	<i>13.3</i>	<i>16 bps</i>
Interest	-34.3	-67.5	96.8
PBDT	3,994.5	4,408.4	10.4
Depreciation	-320.3	-352.9	10.2
Other Income	968.1	1,058.6	9.3
PBT	4,642.3	5,114.1	10.2
Tax	-812.3	-1,021.1	25.7
<i>Tax rate (%)</i>	<i>17.5</i>	<i>20.0</i>	<i>247 bps</i>
Net profit pre exceptional	3,830.0	4,093.0	6.9
<i>Net margin (%)</i>	<i>12.5</i>	<i>12.2</i>	<i>-33 bps</i>
Exceptional Items	1,377.4	-12.4	-100.9
Net profit post exceptional	5,207.4	4,080.6	-21.6

Source: Company Reports

Figure 2. HUL – 3Q07 Key Costs (Rupees in Million, Percent)

Year to 31 Dec	3Q2006	3Q2007	% Change
Sales	30,660.1	33,646.3	9.7
Total Expenses	26,631.3	29,170.4	9.5
Raw/Packing Material	16,226.1	17,856.5	10.0
<i>As % of Sales</i>	<i>52.9</i>	<i>53.1</i>	<i>15 bps</i>
Employee Costs	1,773.4	1,919.0	8.2
<i>As % of Sales</i>	<i>5.8</i>	<i>5.7</i>	<i>-8 bps</i>
Advertising and Sales Promotion	3,402.5	3,545.9	4.2
<i>As % of Sales</i>	<i>11.1</i>	<i>10.5</i>	<i>-56 bps</i>
Other Expenses	5,229.3	5,849.0	11.9
<i>As % of Sales</i>	<i>17.1</i>	<i>17.4</i>	<i>33 bps</i>

Source: Company Reports

Figure 3. HUL – 3Q07 Segment Revenues (Rupees in Million)

Year to 31 Dec (Revenues)	3Q2006	3Q2007	% Change
Soaps and detergents	13,933.0	15,721.5	12.8
Personal care products	8,538.2	8,875.9	4.0
Foods	1,310.7	1,659.9	26.6
Beverages	3,455.4	3,905.1	13.0
Exports	3,273.7	3,135.8	-4.2
Others	480.0	642.1	33.8
Overall segmental sales	30,991.0	33,940.3	9.5

Source: Company Reports

Figure 4. HUL – 3Q07 Segment Profitability (Rupees in Million, Percent)

Year to 31 Dec (EBIT)	3Q2006	3Q2007	% Change
Soaps and detergents	1,720.0	2,625.8	52.7
<i>Margin (%)</i>	<i>12.3</i>	<i>16.7</i>	<i>436 bps</i>
Personal care products	2,283.6	2,147.2	-6.0
<i>Margin (%)</i>	<i>26.7</i>	<i>24.2</i>	<i>-255 bps</i>
Foods	39.0	36.5	-6.4
<i>Margin (%)</i>	<i>3.0</i>	<i>2.2</i>	<i>-78 bps</i>
Beverages	477.1	561.8	17.8
<i>Margin (%)</i>	<i>13.8</i>	<i>14.4</i>	<i>58 bps</i>
Exports	205.2	63.3	-69.2
<i>Margin (%)</i>	<i>6.3</i>	<i>2.0</i>	<i>-425 bps</i>
Others	-154.5	-329.1	113.0
<i>Margin (%)</i>	<i>-0.5</i>	<i>-1.0</i>	<i>-47 bps</i>

Source: Citi Investment Research

Growth Should Pick Up in 4Q

We expect sales growth and margins to pick up in 4Q, given that the Assam facility is back to its normal production levels. Management has stated that primary sales growth levels continue to remain stable, and market shares for HUL (based on primary sales) have been stable in 3Q, suggesting a run down in personal care pipeline inventories. These are likely to be restored in 4Q, and as such, there could be positive surprises in personal care sales growth.

Figure 5. HUL's Market Share Trend (%)

	3Q06	3Q07	Change
Soaps	53.8	52.9	-90bps
Detergents	35.5	37.7	+20bps
Utensil Cleaners	56.2	57.1	+90bps
Toothpaste	30.7	30	-70bps
Shampoos	48.6	47.7	-90bps
Skin Creams	54.4	55	+60bps
Tea	25.8	24.6	-120bps

Source: Company Reports (Sourced from AC Nielson)

Hindustan Unilever

Company description

HUL is the largest consumer non-durables company in Asia. 51%-owned by the Unilever Group, HUL has one of the best-managed businesses in India, in our view, and a record of steady growth spanning decades. It has a diversified product portfolio, including fabric wash, personal care, tea, coffee and staple

foods. Some of the strongest brands in India such as Lifebuoy, Lux, Surf, Wheel, Lakme, Ponds and Lipton are from the HUL stable.

Investment strategy

We have a Buy/Low Risk (1L) rating on the stock. HUL's valuations look attractive after the recent sell-off. The stock is trading at the lower end of its historical trading range and offers downside protection, in our view. HUL's fundamentals are looking up, with a significant pick-up in growth on improving demand from the urban as well as rural segments, especially in the rural areas. Management has increased its focus on market-share gains and as a result investment in brands has picked up. The company has been aggressively launching new product variants and has also undertaken product re-launches, which we believe will continue. With the high-end personal-care segment growing faster, the product mix is also improving. We believe margins could also surprise on the upside, driven by price hikes and declines in commodity prices. Margins have been under pressure in the past few quarters, and we believe they have bottomed.

Valuation

HUL's fairly steady stream of earnings makes P/E a good tool to value the stock. Our target price of Rs254 is based on what we think is a conservative multiple of 27x 2008E P/E, at the mid-end of the stock's historical trading band of 20-35x, over the past 8 years. We choose mid-end as we expect a re-rating for the stock given that its operating parameters are improving. We do not use a top-end multiple, as competitive intensity has increased over last few years and the environment in which HUL operates is not as conducive as before. At 27x P/E, HUL would trade at a 40% premium to the Sensex. The company has historically enjoyed more than a 100% premium to the Sensex owing to its high capital-efficiency ratios and consistent earnings growth. However, we do not expect the stock to re-trace to its historical high premium, given that the company now operates in a different competitive landscape, with higher competitive intensity and a lower margin profile. On EV/EBITDA, we believe the stock should trade at 24x 2008E EV/EBITDA, which gives a fair value of close to Rs250. The stock's trading band has been 20-30x over the past three years.

Risks

We rate HUL as Low Risk because the company operates in branded consumer products and has a diversified product portfolio. The Low Risk rating is consistent with our quantitative risk rating system which tracks the 260-day share price volatility of the shares. The most significant risk to our target price is the possibility of a prolonged battle for market share with other MNC peers as well as Indian companies. HUL is leveraged equally to the rural and the urban economies and, as such, any dislocation would affect the company's performance. Although the company's brands have strong pricing power, in a challenging external environment price increases are limited. PG is aggressively seeking to increase its market share in detergents, shampoos and some other categories. Other downside risks include higher-than-expected raw-material costs and the company's inability to deliver on top-line growth.

Appendix A-1

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Analyst: Princy Singh (covered since February 21 2006)



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